APPENDIX

D

Forecasting Employers' Contributions to Defined-Benefit Pensions and Health Insurance

Most nonwage compensation that employees receive is exempt from income tax. During the next several years, two categories of such compensation—employers' contributions to private defined-benefit pension funds and premiums that employers pay for their employees' group health insurance—are likely to grow rapidly. That growth will reduce the taxable portion of employees' compensation, corporate profits, and the income base on which the corporate tax is levied.

Contributions to Defined-Benefit Pensions

In recent years, employers' contributions to defined-benefit pension plans have surged. According to the national income and product accounts (NIPAs), such contributions more than doubled from 2001 ($36.0 billion) to 2002 ($77.2 billion) and then jumped (to $102.8 billion) in 2003. The growth in contributions occurred because many plans had become underfunded, in some cases by substantial amounts. (Being "underfunded" means that the plans' assets are insufficient to meet their projected liabilities—the pensions owed to current workers and retirees and their survivors.) The plans' underfunding contrasted with the situation that prevailed during the late 1990s, as the boom in the stock market left many plans overfunded. In that instance, not only were firms not required to contribute to defined-benefit plans but they were discouraged from doing so by limits on the tax deductibility of contributions to overfunded plans. When stock prices declined between 2000 and 2002, the value of assets fell, and many plans abruptly became underfunded.

A pension plan's projected liabilities depend on the stream of payments that it expects to make, taking into account its rules and actuarial assumptions about mortality. A further, critical element is the interest rate used to compute the present value—the value in today's dollars—of future payments. The lower the interest rate, the lower the rate at which payments are discounted and, consequently, the higher the value of future payments in today's dollars. Under the Employment Retirement Income Security Act of 1974, which sets minimum standards for funding pension plans in private industry, the interest rate used for discounting must be no more than 105 percent of a weighted average of interest rates on 30-year Treasury securities over the previous four-year period.[1] The 2000-2002 decline in stock prices, however, coincided with a sharp fall in long-term interest rates—which exacerbated the emerging underfunding.

Defined-benefit pension plans received some temporary relief from falling interest rates under the Job Creation and Worker Assistance Act of 2002 (JCWAA) and the Pension Funding Equity Act of 2004. (JCWAA allowed plans to set a rate equal to 120 percent of the weighted-average 30-year Treasury rate in 2002 and 2003; the pension funding act stipulated that for 2004 and 2005, the maximum applicable rate would be a weighted average of rates on amounts "conservatively invested in long-term corporate bonds.") As a result, the maximum applicable rate for most plans was 6.65 percent in 2003 and 6.55 percent in 2004. (Without the legislation, it would have been about 5.8 percent in 2003 and about 5.5 percent in 2004.) The Congressional Budget Office (CBO) estimates that contributions in 2004 to private defined-benefit plans dropped to about $74 billion, or roughly $80 billion below what they would have been without the

1. The Department of the Treasury no longer issues 30-year securities. Consequently, the Internal Revenue Service has published a substitute applicable rate based on the 30-year Treasury bonds that mature in February 2031.

temporary relief provided by the Pension Funding Equity Act.

One consequence of that temporary relief is that the assets of defined-benefit pension plans are now further out of line with their liabilities than they would otherwise be, meaning that future contributions will probably have to be larger. CBO projects that for 2005, defined-benefit contributions will jump to $143 billion, reflecting the lower contribution level in 2004 as well as a decline—to 6.10 percent—in the maximum interest rate applicable to most plans.[2] Under current law, contributions in 2006 are projected to more than double, to about $300 billion, with the expiration of the temporary relief measures and the resultant fall—to about 5.5 percent, based on CBO's interest rate forecast—in the maximum applicable interest rate. But as that year's contributions diminish the funding gap and the interest rate moves upward toward its estimated long-run average of 6.4 percent, contributions in CBO's estimation will fall to about $250 billion for 2007, about $200 billion for 2008, and slightly over $100 billion annually by 2015.[3]

A number of factors—including the future path of stock prices, the risk of default on pension plans' obligations, and changes in interest rates—could make those catch-up contributions either larger or smaller than CBO is forecasting. Several years of rising stock prices could increase the value of assets by enough to eliminate the underfunding in many plans. Conversely, poor performance of the stock market could drive some of the most distressed plans into default, shifting the burden of payments from a plan's sponsors to the federal Pension Benefit Guaranty Corporation. (However, a weak stock market would probably also substantially increase the contributions required for defined-benefit plans that remained in existence.) Although CBO does not attempt to forecast stock prices, it does take their variability into account when projecting defined-benefit contributions (in part because greater variation in stock prices raises the probability that any given defined-benefit plan will go into default). Interest rates are also a factor in such projections. Thus, a large and sustained increase in rates—rendering them higher than the interest rate assumptions incorporated in CBO's baseline—would help lessen the catch-up contributions that firms were required to make.

Contributions to Medical Insurance Premiums

Over the past two decades, fluctuations in the share of compensation that employees receive in the form of benefits have been heavily influenced by employers' contributions to health insurance coverage. Health insurance benefits rose modestly as a share of compensation throughout the 1980s and then surged—between 1987 and 1993, their share of compensation rose from 4.6 percent to 6.2 percent, as employers' hourly cost of providing health insurance (total contributions divided by total hours worked) grew at a double-digit rate (see Figure D-1). But by 1997, the health insurance share of total compensation had fallen to 5.3 percent, as the pace of hourly cost increases slowed sharply.

Since 1998, the growth of those costs has accelerated again—by so much that in 2003, the share of compensation attributable to health insurance reached a record 6.8 percent. Data from the employment cost index indicate that increases in employers' hourly insurance costs for private-sector workers again reached double digits in 2002 and 2003, but by the third quarter of 2004, the year-over-year increase had slowed to 7.3 percent—still roughly double the 3.7 percent rise in total hourly compensation.

CBO expects that over the next several years, the rate of increase in employers' hourly costs for health insurance will continue to slow but still grow at a pace faster than that of overall compensation. A survey of employers by Mercer Human Resources Consulting indicated an average expected rate of increase in health insurance premiums (those paid by the employer and the employee) per active employee of 6.6 percent in 2005, down from 7.5 percent in 2004.[4] During the next several years, the growth of employers' health insurance costs may continue to slow, in part because excess "profits" received by nonprofit insurers will restrain the growth of premiums. However, any slowdown will be limited because the

2. That rate, which comes from the Internal Revenue Service's corporate bond rate table, represents the corporate bond weighted-average interest rate for plan years beginning in January 2005. (Most plans' years begin in January.)

3. That long-run average is based on an assumed spread of 0.6 percentage points between the rates on 10-year and 30-year Treasury securities.

4. Additional details are available at www.mercerhr.com/pressrelease/details.jhtml/dynamic/idContent/1162645.

aging of the workforce and the ongoing introduction of expensive new medical technologies are likely to push medical costs higher.

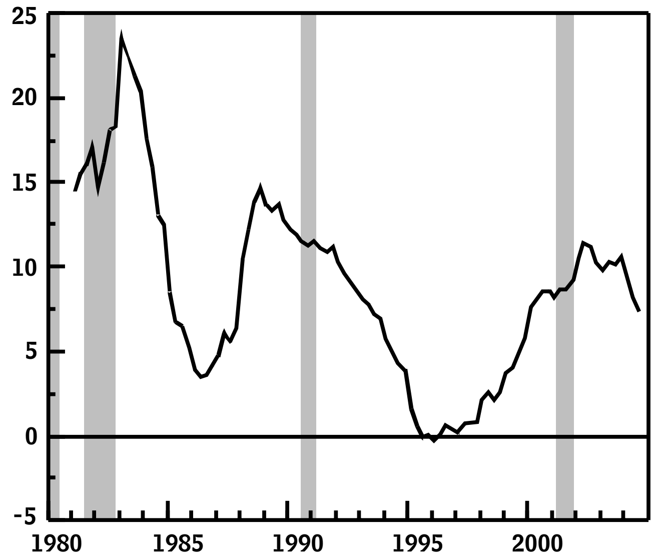
Implications for Projecting Income Shares and Revenues

Increases in employers' contributions to pensions and health insurance would, at first glance, boost labor's share of national income, resulting in lower profits and hence a smaller share of taxable income. However, the available evidence suggests that over a period of several years, most of the increased cost of those contributions will ultimately be borne by workers in the form of reduced wages or other benefits. Consequently, any effect that such increased costs might have on how income is distributed between labor and capital within the NIPAs would be short-lived; in fact, CBO's forecast incorporates the assumption that employers will be able to anticipate both regular pension contributions and increases in health insurance premiums and will take them into account in setting wages. Thus, changes in those factors will have no effect on labor's share of gross domestic product. However, required catch-up contributions to defined-benefit pension plans reflect the belated realization of previously incurred, or "sunk," costs rather than compensation for current workers (even though such contributions are treated as compensation in the NIPAs). Therefore, CBO assumes that catch-up contributions will not be offset by reductions in other forms of compensation and will continue to directly reduce firms' profits.

Figure D-1.

Employers' Hourly Health Insurance Costs

(Percentage change from previous year)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.